

Letter of Findings: 10-0136
Sales and Use Tax
For the Years 2007 and 2008

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ISSUE

I. Utility Exemption – Sales/Use Tax.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-4-5; IC § 6-2.5-5-1; IC § 6-8.1-5-1(c); [45 IAC 2.2-4-13\(e\)](#); [45 IAC 2.2-5-8](#).

Taxpayer argues that it is entitled to the "predominate use" sales tax exemption.

II. Tax Administration–Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten (10) percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana business which designs, manufactures, and sells shoes. Specifically, the taxpayer specializes in making proper fitting, long wearing, repairable shoes for all types of uniquely developed or otherwise deformed feet. The Department of Revenue (Department) conducted an audit review of taxpayer's business records and tax returns for the 2007 and 2008 tax years (Tax Years). The audit revealed that taxpayer did not pay sales tax on electricity used in taxpayer's manufacturing facility during the Tax Years. Taxpayer's facility uses two meters to measure electricity usage. One meter monitors a three phase electricity source, which powers production equipment. The other meter monitors single phase electricity input, which powers both production and non-production equipment and devices. During the audit, taxpayer presented a utility study prepared by a local electrical contractor. Upon careful review of the utility study, the examiner determined that the taxpayer's use of the three phase electrical supply for production equipment satisfied the requirements for an exemption from sales tax based upon predominate use in production. However, with respect to the single phase supply, the examiner found that taxpayer used some of this electricity to power various lighting fixtures, and three roof air units. Based upon this finding, the audit determined that taxpayer directly consumed only thirty-seven percent of the single phase supply for production. The examiner assessed sales tax on the remaining sixty-three percent of electrical consumption originating at this single phase supply. That non-exempt figure included electricity consumed by the lighting and roof air units.

Taxpayer objected, arguing that it was entitled to the "predominate use" exemption for taxpayer's use of the single phase supply because the subject lighting and one of the roof air units were used in direct production of taxpayer's products. Taxpayer protested the imposition of sales tax and penalty. An administrative hearing was held, and this Letter of Findings results.

I. Utility Exemption – Sales/Use Tax.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Indiana imposes a gross retail (sales) tax on certain sales made within the state. IC § 6-2.5-2-1(a). The tax is not imposed on all transactions but only those which constitute "retail transactions."

Sales of public utilities are specifically designated as "retail transactions." IC § 6-2.5-4-5(b) states that, "A power subsidiary or a person engaged as a public utility is a **retail merchant** making a **retail transaction** when the subsidiary or person furnishes or sells electrical energy, natural or artificial gas, water, steam, or steam heating service to a person for commercial or domestic consumption." (**Emphasis added**). Therefore, when the electric utility sold electricity to taxpayer, it was required to collect sales tax.

However, the legislature has seen fit to allow a number of specific sales tax exclusions. See IC § 6-2.5-5-1 et seq. The statute designating utility transactions as "retail sales" refers to one of those exclusions. IC § 6-2.5-4-5(c) states:

Notwithstanding subsection (b), a power subsidiary or a person engaged as a public utility is not a retail merchant making a retail transaction when... (3) the power subsidiary or person sells the services or commodities listed in subsection (b) to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture. However, this exclusion for sales of the services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are **separately metered** for the excepted uses listed in this subdivision. (**Emphasis added**).

Therefore, if a manufacturer purchases electricity to operate a sewing machine, or forming device, which is "directly" used to produce shoes, it is entitled to claim the sales tax exemption as long as there is a means of

directly measuring (i.e. "metering") the electricity used by those respective machines. However, during the Tax Years, taxpayer did not meter its utility usage in a manner which permits a direct correlation between the consumption of the utility services and the production of taxpayer's footwear. Instead, taxpayer necessarily relies on the language contained within IC § 6-2.5-4-5(c)(3). That language permits a manufacturer of tangible personal property to claim the utility exemption "if those [utility] sales are not separately metered but are **predominately used** by the purchaser for the excepted uses listed in this subdivision." (**Emphasis added**). Therefore, in order for taxpayer to claim an exemption from paying sales tax due, or a total refund of all sales tax paid, on the purchase of electricity, taxpayer must demonstrate that the electricity purchased is "predominately used" to manufacture its shoes.

The Department has defined "predominately used" as follows:

Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are predominantly used for excepted purposes. Predominant use shall mean that more than fifty percent (50 [percent]) of such utility services are consumed for excepted use. [45 IAC 2.2-4-13\(e\)](#).

The taxpayer's aforementioned utility study considered all of the equipment and devices hooked up to the single phase supply, and calculated the daily average of those items' combined kilowatt usage. The utility study did not distinguish between exempt and non-exempt uses. In its protest, Taxpayer included photographs of specific areas of its manufacturing facility. To specifically address the audit's determinations regarding the lighting and roof air unit, Taxpayer first asserted that the incandescent lights placed in various locations along the production line provide the increased illumination necessary to manufacture taxpayer's products. Taxpayer argues that the sewing process requires the enhanced lighting at each manufacturing station.

[45 IAC 2.2-5-8\(c\)](#) allows for an exemption on "purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced." Example 4(F) in this regulation excludes ceiling lights. The audit cited this regulation when adjusting taxpayer's exempt and non-exempt usage figures, separately stating the kilowatt hours for "shop lights" and for "sewing lights." Taxpayer's photographs and explanations do not overcome the audit's determination that electricity used to power the shop lights is taxable. However, taxpayer has provided adequate support to allow a sales tax exemption on electricity used to power the sewing lights.

Taxpayer second contends that the predominate use exemption applies to one of the roof air units located in taxpayer's manufacturing facility. Unlike the other two roof air units in the building, taxpayer added humidity control to the subject unit, which resides in that section that taxpayer uses to store raw materials used in production. Taxpayer claims that this unit adds essential humidity to taxpayer's storage area, preventing deterioration of the leathers.

[45 IAC 2.2-5-8\(e\)\(1\)](#) states that "[t]angible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold."

In contrast to taxpayer's photographs displaying the sewing lights as integral parts of the production footwear, taxpayer's photos of the subject roof air unit and (presumably) the contents stored within the taxpayer's storage area do little to contradict the auditor's finding. Taxpayer's photos do not show that the rolls of leather and related materials undergo a change while in the subject storage area. Taxpayer has failed to establish that the taxpayer's use of electricity from its single phase source to power a roof air unit located over taxpayer's storage area satisfies the "work in progress" requirement.

FINDING

Taxpayer's protest is sustained to the extent that electricity used to power sewing lights should be exempt from sales tax, subject to review in a supplemental audit. However, taxpayer's protest is respectfully denied with respect to an exemption from sales tax on electricity used by the subject roof air unit, which also supports the Department's denial of taxpayer's protest regarding an exemption from sales tax based upon predominate use of the single phase electricity source.

II. Tax Administration—Negligence Penalty.

DISCUSSION

In addition to proposed assessments, the Department also assessed ten (10) percent negligence penalties for the Tax Years. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as

negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in [45 IAC 15-11-2\(c\)](#), as follows:

The department shall waive the negligence penalty imposed under [\[IC 6-8.1-10-2.1\]](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has provided sufficient information to establish that its failure to pay sales and use tax was not due to Taxpayer's negligence, but was due to reasonable cause as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest to the imposition of the penalty is sustained.

CONCLUSION

In summary, Taxpayer's protest of the Department's sales tax assessment on electricity use is sustained in part and denied in part, subject to a supplemental audit; and Taxpayer's protest of the penalty is sustained.

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